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# **Japanese Capital Exports: Looking Behind the Flood of Money**

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**An Intelligence Assessment**

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June 1987*

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# Japanese Capital Exports: Looking Behind the Flood of Money

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**An Intelligence Assessment**

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This paper was prepared by [redacted] Office  
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**Japanese Capital Exports:  
Looking Behind the Flood  
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**Scope Note**

Massive outflows of funds over the past five years have turned Japan into one of the world's largest creditors. The Japanese private sector is primarily responsible for these outflows in the form of bank loans, direct investments, and securities purchases. This paper—which focuses on Japan's overseas stock and bond investments—is the third in a series of assessments on Japan's growing role as an international investor.

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**Key Judgments**

*Information available  
as of 1 June 1987  
was used in this report.*

With \$700 billion in overseas assets, Japan is well on the way to becoming the world's foremost creditor nation. This development will affect the United States more than other countries because the Japanese private sector—which owns the bulk of overseas investments—is focusing on buying assets from the United States. The record on Japanese investment to date suggests that, on balance, the impact on the United States will be beneficial:

- Perhaps most important in the near term is the fact that Japanese investors are providing money to US—as well as international—financial markets badly in need of funds. Japan financed an estimated one-third of the US budget deficit last year through its purchases of government securities. Direct investments in US firms also have grown, increasing jobs and boosting US economic growth.
- Over time, growth in Japan's overseas portfolio may encourage a broader Japanese role in foreign affairs, although the factors that have inhibited a more internationalist and assertive involvement—including the conservative nature and the aversion to risk-taking of Japan's bureaucracy and ruling party—will ensure that such changes are slow in coming. Nonetheless, we expect Tokyo to take a higher profile in international financial institutions and argue for more market-oriented policies in developing countries in order to improve the environment for Japanese investors and exports.

Huge Japanese overseas investments also pose several risks. Most important, US financial markets would be adversely affected if Japanese investors decided to sell large quantities of US securities. Under such circumstances, US interest rates almost certainly would rise to attract new investors and the dollar depreciate sharply, developments that could result in renewed inflation and a slowdown in economic growth.

The Japanese Government would be unlikely to induce such selling for either economic or political reasons, in our view, but our analysis of Japanese investment behavior suggests that a shift out of US securities is possible. Japanese investors, who are increasingly active in managing their portfolios, are primarily concerned with earning high rates of return with low risks. In our view, there is little doubt that better returns elsewhere, the

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prospect of a US recession, or a sharp drop of the dollar would lead them to move a large share of their assets out of the United States. Given their inherent stability, the stock of direct investments—such as industrial plants—are less vulnerable to sudden changes in investor attitudes.

[redacted] Japanese policymakers already are concerned with the possibility that overseas Japanese investments could also lead to new economic friction. The Japanese stake in US real estate and manufacturing, for example, is highly visible—often in areas once battered by Japanese import competition. In addition, the continued flow of Japanese bond and stock investments is being accompanied by a larger role for Japanese financial institutions, cutting into markets once dominated by US banks and securities houses.

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## Japanese Capital Exports: Looking Behind the Flood of Money

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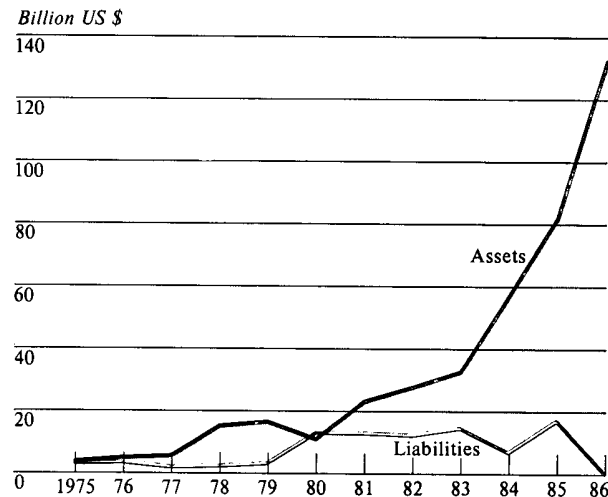
### Japanese Capital Exports: A Snapshot

Japan's overseas assets have increased dramatically over the last four years. The rest of the world now owes Japanese investors approximately \$700 billion—up from only \$270 billion in 1982—making Japan the world's third-largest creditor behind the United States and Great Britain. With considerably fewer external liabilities—primarily short-term loans—than the United States or Great Britain, however, Japan is the world's largest net creditor. Japanese overseas investments have helped to finance economic growth in the United States and Western Europe over the past few years. But, at the same time, they have helped to pay for Western imports of Japanese products, thereby contributing to the large trade imbalances which now plague the international economy.

To date, the bulk of the overseas assets acquired by the Japanese have been in the form of foreign securities—stocks and bonds. They account for nearly 70 percent of the outflow of long-term capital from Japan since 1981. Last year such purchases alone exceeded the current account surplus by \$16 billion. Bond purchases account for most of the securities acquisitions. Ninety-three percent of all foreign securities the Japanese bought last year were bonds, with a heavy emphasis on dollar-denominated purchases. Dai-ichi Mutual Insurance, Japan's second-largest insurance company, estimates that 60 percent of Japan's overseas bond holdings are dollar denominated and were purchased in the United States or Western Europe.

By comparison, loans and direct investment currently represent a small portion of capital outflows. Overseas loans by Japanese banks have accounted for only 16 percent of long-term capital outflows since 1981. In yen terms, such lending grew only 6 percent a year during the 1980s as Japanese banks cut back credit extended to troubled Third World debtors and as borrowers in developed countries increasingly chose to raise funds by issuing securities rather than by taking

**Figure 1**  
**Japan: Long-Term Capital Flows, 1975-86**



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out bank loans. As a share of the outflow, direct investment fell steadily during the early 1980s to only 8 percent of the total in 1985, but increased to 11 percent last year. The upswing occurred largely because Japanese firms expanded abroad to take advantage of lower production costs and to circumvent protectionism in Western markets.

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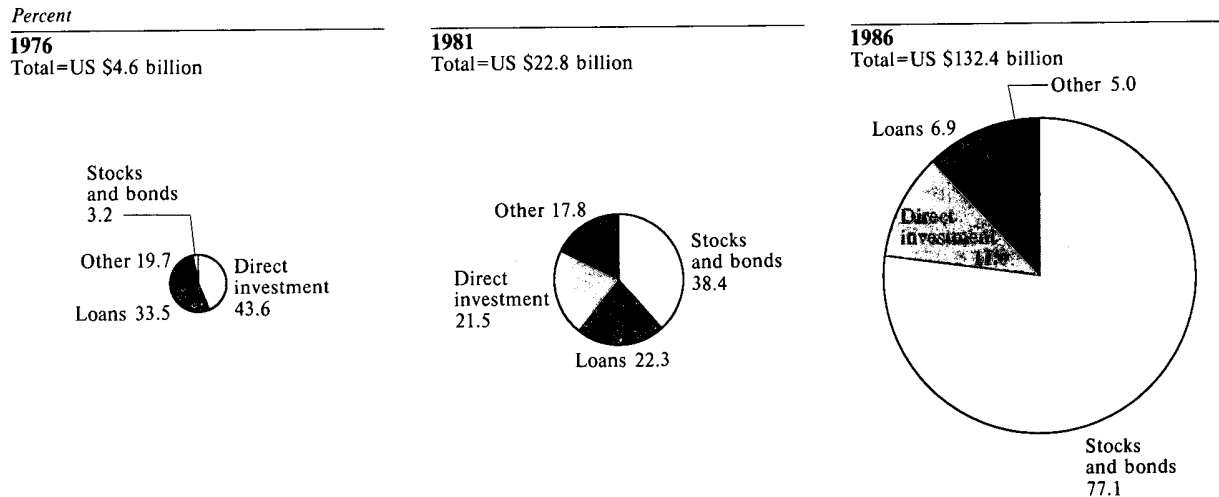
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The Japanese private sector owns the vast majority of overseas assets. As in other industrial countries, financial institutions handle the bulk of this private-sector activity. Over the last two years, for example, Japanese banks, trusts, and insurance companies were



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**Figure 2**  
**Japan: Long-Term Asset Acquisitions, 1976, 1981, and 1986**



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responsible for nearly 65 percent of the increase in overseas stock and bond holdings. Nonfinancial companies, primarily large exporters, apparently accounted for the remaining 35 percent. [redacted]

The Japanese Government directly controls little of the country's external assets. The government's overseas portfolio represents only 20 percent of Japan's total overseas assets, with the central bank's foreign exchange reserves accounting for the majority of the government's overseas holdings. Nonetheless, there are signs that the government could become a larger overseas investor over the next several years:

- The Finance Ministry's Trust Fund Bureau—which manages over \$1 trillion in assets—is now permitted to invest in bonds issued by foreign governments, international organizations, and special foreign foundations. Even though the amount invested in foreign securities is not to exceed 10 percent of the

Fund's total assets, the potential effect on capital outflows is striking; 10 percent of the Fund's assets amount to \$113 billion.

- Beginning in October, the Ministry of Posts and Telecommunications (MPT) will be permitted to manage \$6 billion of the postal savings now handled by the Trust Fund Bureau. The amount will be gradually increased to \$18 billion by 1991. According to press reports, MPT officials are interested in investing some of the funds in foreign bonds, particularly World Bank securities. [redacted]

#### **The Move Overseas**

We believe the brisk purchase of overseas assets, particularly securities, will continue over the next few years, giving Japanese investors an even higher profile

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**Key Players in Overseas Securities Purchases**

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**Trust Banks**

*Manage the country's huge pension funds and accept deposits—tokkin funds—from cash-rich corporations and other financial institutions.*

**Securities Companies**

*Manage corporate cash and accept deposits for the country's popular mutual funds.*

**Investment Management Companies**

*Often affiliated with banks and securities firms. These companies manage tokkin funds for trust banks and mutual funds for securities firms.*

**Life Insurance Companies**

*Manage life insurance funds and some corporate pension funds. Major force that boosts growth in assets has been a saving-type insurance policy, whose main attraction is high interest and guaranteed principal at maturity.*

**Investment Advisory Companies**

*Usually very small and thinly capitalized companies offering personal investment advice. With passage of new law last year, they must now obtain licenses as well as set aside money for the protection of investors. Some will be allowed to engage in the discretionary management of funds.*

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in foreign financial markets. Nomura Research, the consulting arm of Japan's leading securities company, estimates that Japan will pass the United States by the early 1990s to become the world's largest holder of overseas assets. In our judgment, Nomura's prediction appears to be sound. Personal savings—already \$3.2 trillion or \$26,000 per person—are increasing by an average annual growth of nearly 10 percent, which would provide Japanese investors with the funds for much of this growth. In addition, ongoing restructuring of Japanese portfolios away from domestic to foreign financial investments is on the rise, which also will add to the funds available. In the last two years, for example, this restructuring accounted for about 75 percent of the increase in overseas securities holdings by financial institutions.

In our judgment, two factors are driving the reallocation of Japan's savings toward foreign securities:

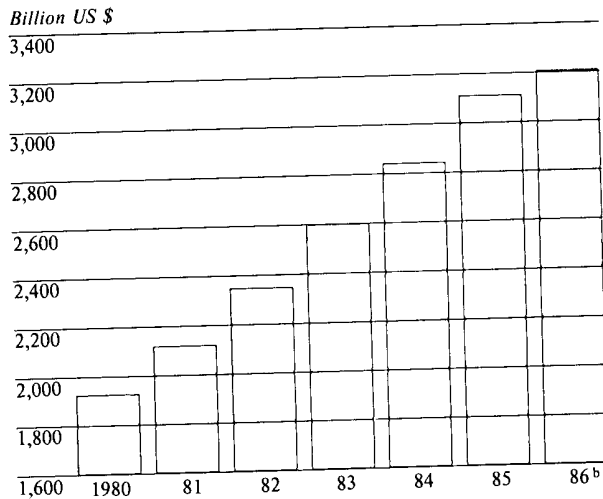
- *A more competitive environment for money management in Japan.* Financial deregulation in Japan has widened individual saver's options. As households demand higher returns on their savings, financial institutions are forced to seek out first-rate investments in order to offer competitive deposit rates. This has focused attention on foreign securities, whose rates of return have been higher than those at home. The spread between yields on long-term US Government securities and comparable Japanese Government securities, for example, has averaged 4.3 percentage points since 1981 and topped 5 percentage points for most of 1984 and early 1985.

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**Figure 3**  
**Japan: Personal Savings<sup>a</sup>, 1980-86**



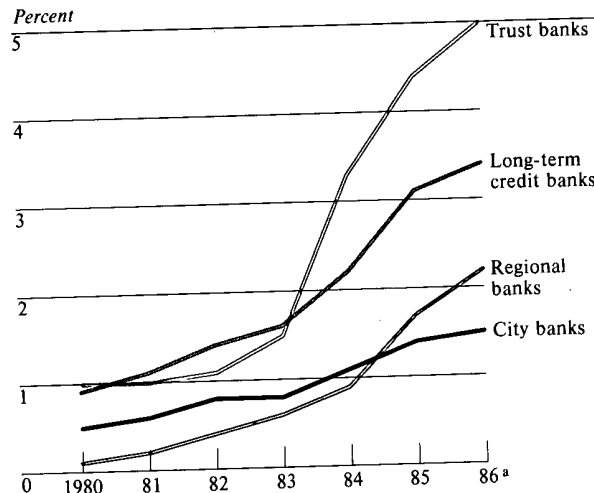
Note: All figures are for end of year.

<sup>a</sup> Converted at 160 yen to the US dollar.

<sup>b</sup> As of June.

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**Figure 4**  
**Japanese Banks: Overseas Securities Holdings as Share of Total Assets, 1980-86**



<sup>a</sup> Mid-1986.

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- **Aging of the population.** Japan is in the midst of a rapid demographic transition that will make its population the oldest in the world by 2025. In order to support the large numbers of retirees, Tokyo estimates that tax rates will have to jump sharply, which some analysts believe could spell the end to Japan's economic dynamism. As such, overseas investments are attractive because they will help Japanese investors maintain high incomes even though Japanese economic growth slows.

In recent years the government has implemented policies that probably will encourage investors to move funds overseas. In particular, the foreign exchange law promulgated in 1980, while continuing to regulate some capital transactions, embraced the principle that restrictions would henceforth be the exception rather than the rule. Tokyo has pursued this policy by giving financial institutions more freedom to invest abroad. In April 1986, as a case in point, the Finance Ministry raised the ceiling on the proportion

of a trust bank's total assets that could be invested abroad from 10 to 25 percent. Insurance companies—which bumped up against the 10-percent ceiling in late 1985—were given the same latitude in May 1986, and the limit for both groups was further raised to 30 percent in August.

#### A Question of Stability

Considering that Japanese overseas investments will loom large well into the 1990s, the effect of Japanese investment practices on the stability of international financial markets becomes a significant question. The answer, in our view, is by no means clear cut, but we have noted several patterns in Japanese investor behavior that bear watching. First, there appears to have been an increasingly rapid turnover of Japanese securities investments in the past few years. The ratio of overseas bond purchases to sales has declined sharply, indicating that Japanese investors are no

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longer holding securities for long periods. In 1985, Japanese investors held US bonds an average of only two months before reselling them—a pattern that continued into 1986. [redacted]

This investment practice, which makes Japanese portfolios more active, and therefore volatile, appears designed to produce capital gains. It has paid off well.

[redacted] the short-term trading of securities has provided huge profits to Japanese corporations.

[redacted] the lure of capital gains, along with falling US bond prices, is fueling Japanese interest in the US stock market. According to US financial analysts, Japanese investors provided nearly one-third of the new funds in the market in late 1986, and [redacted] the pace should quicken further this year. Japanese institutional investors will probably provide the bulk of the new funds. Press reporting suggests that they are likely to concentrate on less risky blue-chip issues, although Japanese investors are showing a growing interest in biotechnology and electronic stocks. [redacted]

Rapid turnover in securities portfolios will probably remain a Japanese practice. Japan's tax laws do little to constrain investors from pursuing capital gains, and, in general, capital gains from the sale of stocks and bonds are exempt from personal income taxes. In addition, although corporations must pay tax on capital gains, much of the trading of securities by pension funds and trust banks is also tax exempt because earnings on this property are treated as if the beneficiary—often individuals—actually owns the securities. [redacted]

One implication of this active Japanese investment strategy is the likelihood that global financial markets will become more volatile. A shift of only 1 percent of Japan's overseas asset holdings from bonds to stocks, for example, would represent a move of \$2.5 billion—

an amount equal to one-third the average daily turnover on the New York Stock Exchange. At minimum, market participants will need to closely monitor Japanese investment practices because decisions by Japanese institutional investors will increasingly influence exchange and bond activity. [redacted]

#### A Selloff of US Assets?

For the most part, the ways that Japan developed its economic relations with the United States in the last few decades have led to an exceptionally stable relationship between the two countries. Japanese manufacturing firms' penchant for carving out and maintaining market share rather than going for a quick profit, for example, means that these companies plan on remaining in the US market. In addition, the recent trend toward larger Japanese direct investments in the United States produces a continuing stake in the health of the US economy. [redacted]

The interest of Japanese financial investors in short-term profits, however, suggests to us that these investments could be one area of the relationship that promises to be more unstable. Indeed, economic factors could lead Japanese investors to consider a shift out of US assets. Such a move apparently already occurred on a small scale earlier this year. In the face of rising US interest rates and a sharply appreciating yen, Japanese investors marginally reduced their holdings of US securities in March. Overall, net Japanese foreign bond buying dropped from \$10.5 billion in January to \$1.5 billion in March, and we suspect that most of the decline was in dollar bonds issued in the United States. [redacted]

[redacted] life insurance companies were the most aggressive in reducing the share of US dollar assets in their portfolios, largely because of jitters about the potential for further yen appreciation. That concern is particularly critical to these companies—which hold the bulk of Japan's overseas bonds—because they are not permitted to fully hedge their overseas securities acquisitions. The prevalence of hedging among other Japanese investors should prevent a significant shift out of US assets strictly for exchange rate reasons. [redacted]

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***What Determines the Yen Exchange Rate?******Japanese Trade***

*Represents a direct demand for currencies. Higher Japanese exports, for example, tend to strengthen the yen because traders need yen to purchase Japanese goods. The purchase and sale of foreign exchange for trade, however, accounts for only a small portion of total exchange market transactions.*

***Japanese Capital Flows***

*Account for the bulk of foreign exchange transactions. A capital outflow from Japan raises the demand for foreign currencies and thus weakens the yen. Not all capital flows, however, result in a currency exchange—the Japanese purchase of yen-denominated Eurobonds is a good example. In addition, some hedged investments require two offsetting transactions, which significantly reduce the impact on exchange rates.*

***Central Bank Intervention***

*The sale of yen and purchase of dollars by the Bank of Japan tends to weaken the yen. The recent increase in the Bank's foreign exchange reserves from \$38 billion in December to \$63 billion in April indicates a considerable effort by the Bank to halt the appreciation of the yen.*

***Non-Japanese Currency Exchanges***

*Exchanges of yen that do not involve Japanese residents. Could involve the operations of another central bank or the sale of a non-Japanese product that is priced in yen. These transactions do not show up in the Japanese balance of payments.*

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The recent small selloffs of US securities have raised the possibility that certain developments could lead Japanese investors to significantly lower their US bond holdings. Some of these developments depend on Japanese Government policy, on private-sector decisions in Japan, and on general economic and market trends in the United States:

- *A narrowing of the interest rate differential between Japan and the United States because of higher interest rates in Japan.* This could occur if Tokyo aggressively pursues an expansionary fiscal policy without a concurrent easing of monetary policy. Higher yields on Japanese Government bonds also would induce Japanese investors to transfer funds from US to Japanese securities, although aversion to an easy fiscal policy make this scenario unlikely, in our view.
- *Alterations in Japanese investment strategy.* If the Japanese become more willing to take risks in their investments, they would be likely to look beyond the United States to other markets, such as Australia and South Korea, that offer the prospect of higher returns. Although we believe this situation will develop only slowly, Japanese investors are beginning to learn the investment management game, and most analysts expect them to become more aggressive as time passes.
- *A crisis of confidence in US markets.* Such a situation could develop if the Japanese came to believe the US economy was headed for a steep recession or if the dollar began a free fall. The result would be a selling of US assets to avoid sharp exchange rate-related losses.

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**Securities Purchases and the Yen Appreciation**

*Japanese overseas investors have faced extensive exchange rate risks over the past two years. As the yen appreciates, the yen value of an investment denominated in other currencies falls. Japanese investors have tried to minimize the risk by borrowing dollars short term—primarily from overseas branches of Japanese banks—to purchase long-term securities. Although yen appreciation would still lower the yen value of the hedged investment, it also would reduce the yen value of the short-term loan that must be repaid. The number of hedged investments—which Nomura Securities estimates at 60 percent of total securities purchases—increased rapidly when the yen began its dramatic appreciation in 1985. This suggests to us that in periods of exchange-rate instability, the spread between short-term US interest rates and long-term rates becomes as important to maintaining Japanese capital flows as differences between yields in Japan and the United States.*

*Even those investors who chose not to hedge, however, did not fare too poorly until recently. In 1985 and 1986, investors apparently believed that the expected decline in US interest rates—and the capital gains it creates—would offset expected losses caused by further yen appreciation. For the most part, they were right. The yen value of a 20-year US Government bond, for example, purchased immediately after the September 1985 Plaza agreement fell only slightly by the end of 1986, despite a 50-percent appreciation of the yen. These huge exchange rate losses were almost fully offset by the sharp decline in US interest rates over the past two years. Japanese investors are growing more concerned now, however, because interest rate declines in the United States are no longer accompanying yen appreciation.*

We doubt the Japanese will be large sellers of US assets in the near term, but, if events prove us wrong, the implications for US financial markets would be serious. Perhaps the most crucial would be the loss of an important source of financing for US Government

debt. US financial analysts estimate that the Japanese purchased roughly one-third of all US Government debt issued in 1986. Should they sell large quantities of US securities, bond prices would fall sharply, pushing up yields to a level that would attract new investors. Higher interest rates, in turn, would probably act to slow US economic growth. Indeed, the small selling earlier this year coincided with a 1-percentage point jump in yields on US Government securities. Because investors transferred some of the money to the Japanese bond market, there was also a drop in yields on Japanese bonds, which both lowers the cost of financing Tokyo's deficit and encourages private-sector investment in Japan.

**A Securities Selloff: Tokyo's Role**

Although the convergence of economic factors that would encourage massive and long-term Japanese selling of US assets seems unlikely, some members of the US financial community have raised the fear—mistakenly, in our view—that the Japanese Government would direct selling to gain political leverage. They posit the eruption of a trade war between the United States and Japan as the most likely scenario precipitating the move, suggesting Tokyo might threaten to call on its private sector to dump US investments unless Washington revised its policies.

we believe there are important reasons to discount the scenario.

Most obviously, the argument that Japan would use financial flows as a political weapon ignores Tokyo's long-term economic interests in the United States and overstates the Japanese Government's influence over Japanese financial institutions.

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If it gains a larger voice in the IMF and World Bank, Tokyo probably would push for more market-oriented policies, such as increasing the conditionality of World Bank lending and encouraging private-sector activity in less developed countries—in part to make these countries more attractive to Japanese direct investment. [redacted]

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We expect that, when developing countries press for additional Japanese investment, Tokyo will stress market-oriented themes designed to facilitate Japanese direct investments and make them more profitable. Japanese officials already are taking steps in this direction. [redacted]

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[redacted] the liberalization of Japanese financial markets, which is weakening the close ties that once existed between banks and the Finance Ministry, puts clear limits on the government's ability to use administrative guidance to direct private-sector investment decisions. In today's more competitive marketplace, in our view, few Japanese investors would be willing to shift from profitable investments or stick with unprofitable ones simply because the government asked. Indeed, both the Finance and Trade Ministries apparently failed in an attempt to prevent Japanese investors from selling US securities in late March. This suggests to us that Tokyo would have to resort to more drastic measures—such as capital controls—if it wanted to use private investments as a weapon. In our view, however, Tokyo would be very reluctant to impose capital controls, unless they viewed the situation as particularly serious. [redacted]

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[redacted] Trade and Industry Minister Tamura recently offered to increase Japanese assistance to the Association of Southeast Asian Nations if its member countries made their investment opportunities more attractive, including relaxing equity restrictions, local content requirements, and employment regulations. Developing countries have so far responded cautiously, in part because Tokyo cannot guarantee that additional private investment will follow. In any case, Japanese success on this issue probably depends on the region—with the likelihood being higher that their advice will be followed in southeast Asia, where they have a larger presence, and less so in Africa and Latin America. [redacted]

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#### Broader Policy Implications

The more dramatic speculation about how Japan could gain political leverage from its financial clout also obscures several important and, in our view, far more likely consequences of Japanese behavior. As a major financial and trading power, the Japanese Government and the private sector together are likely to maximize their leverage on several issues of critical importance to them. One of Japan's most clearly stated goals is to enhance its influence in international financial institutions. Tokyo already increased its voting share in the World Bank last fall and hopes to do the same in the International Monetary Fund (IMF) when the Fund replenishment is considered in 1988. [redacted] Japan is now number five in the Fund in terms of voting strength but would like to be second only to the United States.

In the same vein, Tokyo will probably increasingly press Washington for policy changes that would improve the environment for its US investments. Such pressure has already taken several forms. Several years ago, the government, along with large Japanese firms, sought the repeal of unitary taxation measures, which Tokyo insisted discouraged private investment in states such as California. At present, most of Tokyo's suggestions concern investment-related macroeconomic policies. [redacted]

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Still, Tokyo probably will limit its aggressiveness, partly because Japanese officials fear provoking anti-Japanese sentiment that could damage other aspects of Tokyo's foreign relations:

- Many Japanese direct investments in the United States are highly visible and require the presence of Japanese management in regions once battered by trade competition from Japan. Japanese bankers are already concerned that large investments in US real estate could create a backlash in the United States



- Japanese direct investments in developing countries are often sensitive because they threaten local economic interests that often have considerable political influence. A case in point is the furor raised over a Japanese firm's investment in a large Philippine copper mine in 1985. Other Philippine copper mining firms were concerned about the increased competition from a Japanese-owned and -managed mine.

- Tokyo will also move cautiously because Japanese banks and securities firms, which want to handle a large chunk of Japan's capital exports, already have been accused of underpricing financial services to obtain market share—an argument similar to that made of Japanese manufacturing firms in the late 1970s and early 1980s.

The effect of Japan's huge overseas assets on Tokyo's policy outside the strictly economic arena is less clear. Some analysts have suggested that Japan will follow the path taken by Great Britain in the 19th century and the United States after World War II, when a rapid rise in overseas assets coincided with the development of internationalist foreign policies. The innate

conservatism of Japan's bureaucracy and ruling party argue against the rapid changes that occurred in the British and US cases, in our view. Indeed, the interests of Japan's postwar elite and bureaucracy have long been dominated by the goal of economic growth, and we believe both the national policy consensus and the policymaking establishment would need to be restructured if Tokyo wanted to emphasize other foreign and security policy goals. In addition, Tokyo's interests have historically been more narrowly focused than Washington's or London's. Both Britain and the United States enjoyed a position as the world's foremost military power as they became the dominant creditor—a status that Tokyo obviously does not share. Even during the first half of this century—when Japan was pursuing an active foreign policy—Tokyo limited its horizons to Asia in contrast to the global focus taken by the United States and Great Britain.

Nonetheless, over the longer term, several factors—combined with Japan's creditor role—could draw Tokyo out. Structural changes in Japan's economy over the next several years will probably challenge traditional policy views, such as maintaining a relatively closed economy. For one thing, the growing shift to service industries suggests that the Japanese economy will be less vulnerable to the higher imports that a more open economy would produce. Moreover, the rapid aging of the population that is expected late in the 1990s may lead to an increased Japanese interest in bringing home the money extended to foreigners. Both factors could encourage Japan to open its economy to the traditional method of repayment—imports of foreign goods. In the past, liberalized trade has led to more active foreign policy, in part because governments maneuver to protect foreign sources of supplies.

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